SIDLEY AUSTIN BROWN & WOOD LLP

CHICAGO
DALLAS
LOS ANGELES
NEW YORK
SAN FRANCISCO

1501 K STREET, N.W.
WASHINGTON, D.C. 20005
TELEPHONE 202 736 8000
FACSIMILE 202 736 8711
www.sidley.com

FOUNDED 1866

BEIJING
GENEVA
HONG KONG
LONDON
SHANGHAI
SINGAPORE
TOKYO

WRITER'S DIRECT NUMBER
(202) 736-8224

WRITER'S E-MAIL ADDRESS
cbeckner@sidley.com

January 31, 2003

Marlene H. Dortch
Secretary
Federal Communications Commission
445 12th Street, S.W.
Room TW-A325
Washington, D.C. 20554

Re: *Review of the Section 251 Unbundling Obligations of Incumbent Local Exchange Carriers* – CC Docket Nos. 01-338, 96-98, 98-147

Dear Ms. Dortch:

I am writing on behalf of AT&T Corp. ("AT&T") to respond to recent filings from the Bell operating companies ("the Bells") in which they have argued that the Commission should eliminate unbundled access to dedicated transport and high capacity loops in many geographic regions on the theory that the market for services provided over these facilities is "contestable."[1] Contestability, in the Bells' view, is apparently shown by the presence of a single alternative to the Bells on the route in question. Thus, the Bells claim that where this condition is met, market forces will constrain their prices for services provided over high capacity transmission facilities and, as a result, competitive carriers are not "impaired" without unbundled access to these facilities. Every link in this chain of reasoning is wrong.

As an initial matter, the type of "contestability" analysis proffered by the Bells is simply irrelevant to "impairment" under section 251(d)(2) of the Communications Act. As the Supreme Court stressed in *Iowa Utilities Board v. FCC*, the impairment inquiry must focus on the extent to which a facility is "availabl[e] . . . outside the incumbent's network," whether that be through self-deployment or purchase from a competitive third party wholesaler.[2] And in *United States Telecom Ass'n v. FCC*, the court of appeals held that self-supply could not generally be considered feasible unless it could be shown that cognizable entry barriers are

---

[1] *See, e.g.*, *Ex Parte* Letter from Brian Benison to Marlene Dortch (filed Jan. 29, 2003).

[2] 525 U.S. 366, 392-93 (1999).

sufficiently attenuated that "*multiple*" carriers could profitably duplicate the facility in question.[3] Indeed, according to the Supreme Court's authoritative interpretation, the Act is intended to allow "hundreds" of new entrants to access elements that are "costly to duplicate" even if there are some "large competitive carriers" with the "resources" to replicate the elements economically.[4] It is for precisely these reasons that the Bells themselves have conceded that "the mere presence of a single competitive facility in a particular market [does not] necessarily preclude[] a finding of impairment in that market."[5]

Further, de-listing transport or high capacity loops based on the facilities of a single competitor would be inconsistent with the recognized purpose of the Act. As the Commission explained in the *UNE Remand Order*, eliminating unbundling where there is only one alternative to the incumbent carrier would risk the creation "stagnant duopolies" that would defeat the Act's objective of "creat[ing] competition among multiple providers of local service that would drive down prices to competitive levels."[6] And in the recent *Echostar-DirecTV Merger Order*, the Commission reaffirmed that a duopoly market structure is unlikely to produce competitive prices.[7]

In all events, the Bells simply do not understand the theory of contestability or the application of that doctrine in this context. A market is "contestable" only when the *threat* of entry is sufficient to constrain the prices charged by a dominant incumbent.[8] But critically, this result will only obtain "*in the absence of barriers to entry and exit.*"[9] That is emphatically not the case here for several independent reasons.

---

[3] 290 F.3d 415, 426-28 (D.C. Cir. 2002) (emphasis added).

[4] *Verizon Tel. Cos. v. FCC*, 122 S. Ct. 1646, 1672 & n.27 (2002).

[5] SBC Reply at 10 (filed July 17, 2002).

[6] *UNE Remand Order*, 15 FCC Rcd. 3696, ¶ 55 (1999)

[7] *EchoStar-DirecTV Merger Order*, 17 FCC Rcd. 20559, ¶ 103 (2002) ("[E]xisting antitrust doctrine suggests that a merger to duopoly or monopoly faces a strong presumption of illegality."). *Accord, Horizontal Merger Guidelines* § 3.4 (emphasis added) (entry is not "sufficient" unless "*multiple entry generally is possible* and *individual entrants may flexibly choose their scale*.").

[8] *See generally* William J. Baumol, John C. Panzar, & Robert D. Willig, CONTESTABLE MARKETS & THEORY OF INDUSTRY STRUCTURE (1982); Jean Tirole, THE THEORY OF INDUSTRIAL ORGANIZATION (1988).

[9] Richard Gilbert, *Mobility Barriers and the Value of Incumbency*, in I HANDBOOK OF INDUSTRIAL ORGANIZATION 527 (Richard Schmalensee and Robert Willig, eds. 1989) (emphasis added).

First, "[c]entral to the contestability result is the assumption that no costs are sunk."[10] Absent sunk costs, a potential rival has the potential ability to engage in "hit-and-run" entry should the incumbent try to increase prices above competitive levels. Here, however, a competitive carrier can deploy bypass transmission facilities only by sinking substantial costs.[11] Accordingly, such targeted entry is not possible because the investment is stranded upon exit. "Hit-and-run" entry is also not possible in this context because it takes substantial time for competitive carriers to deploy transmission facilities.[12]

Second, markets are contestable only where entrants have the "same cost at each level of output."[13] But here, second mover competitive carriers that seek to deploy transmission facilities have to bear substantial costs that the Bells did not. For example, municipalities and landlords are often unwilling to give competitive carriers access to necessary rights-of-way on the same terms and conditions as the incumbent.[14]

This essential pre-condition for contestability is particularly unlikely to be met where the incumbent carrier enjoys a substantial scale-driven cost advantage, as is the case for transmission facilities. Even if it were realistic to believe that competitive carriers could obtain financing to deploy a transmission network that duplicates the incumbent's and, therefore, achieve the same economies of scale, entry would still be unlikely. "Rational entry decisions are based on the prices that will prevail *after* entry."[15] When substantial amounts of sunk capacity are added to a market – which would be the case if an entrant attempted to duplicate the incumbent's transmission network – all participants face increased pressure to lower prices towards marginal costs. But because the lion's share of the costs of transmission facilities are

---

[10] *Id.* at 527. *See also* Ronald R. Braeutigam, *Optimal Policies for Natural Monopolies* 1303-04 in II HANDBOOK OF INDUSTRIAL ORGANIZATION 527 (Richard Schmalensee and Robert Willig, eds. 1989) (markets are contestable only "as long as there are no 'sunk' costs").

[11] Robert D. Willig, "Determining 'Impairment' Using the *Horizontal Merger Guidelines* Entry Analysis" at 8-16 (attached to *Ex Parte* Letter from C. Frederick Beckner III to Marlene Dortch (filed December 3, 2002)) ("Willig *Guidelines* Ex Parte");

[12] AT&T Reply at 174-79, 207 (filed July 17, 2002); *see also id.*, Fea-Giovannucci Reply Dec. ¶¶ 30-37, 65.

[13] Gilbert, *supra* at 527; *see also* Baumol *et al.* at 282; Braeutigam, *supra* at 1304-05.

[14] *See Ex Parte* Letter from Judge Robert Bork to Chairman Michael Powell at 7 (filed Jan. 10, 2002) ("As first movers, the incumbent telephone companies received rights-of-way from local governments for underground cables and telephone poles and wires with only minimal transaction costs, because persons in the neighborhood or municipality otherwise would not receive *any* telecommunications services. In contrast, local governments often do not see significant benefits in local competition and are not eager to have multiple companies trenching streets.").

[15] Willig *Guidelines* Ex Parte at 5.

fixed, this pressure will make it increasingly unlikely that the entrant could charge prices that would enable it to recover all of its costs.[16] The potential entrant, understanding this *ex ante*, would rationally choose not to enter under these conditions.[17]

Finally, a market is "contestable" only when "switching costs . . . are non-existent."[18] That, of course, it not the case here. AT&T and other competitive carriers have to expend substantial resources to lure customers away from the Bells. And even when they "win" the customer, many customers refuse to permit competitive carriers to "roll" them to their own last mile facilities, but insist that they continue to use the Bells' facilities for service.[19] Likewise, the Bells have tied up many customers with long-term contracts with early termination penalties. These can constitute a "formidable entry barrier . . . by precluding any further potential entrants from the business that the contract has tied up."[20]

Notably, the Commission itself has recognized precisely these points. For example, in the *UNE Remand Order* the Commission held:

---

[16] Willig *Guidelines* Ex Parte at 8-16. *See generally Ex Parte* Letter from Joan Marsh to Marlene Dortch (filed Nov. 25, 2002) (quantifying the fixed costs of transmission facilities).

[17] In his January 14, 2003 *ex parte* letter, SBC consultant Dr. Shelanksi suggests that these considerations are not cognizable entry barriers because "stranding costs is a normal part of business in most markets." This is manifest nonsense. Although entry into many industries may involve some sunk costs, AT&T here has demonstrated that deployment of transmission facilities requires extraordinary levels of sunk costs. *See* Willig *Guidelines* Ex Parte at 8-16. Further, AT&T is not merely relying on the existence of sunk costs, but the fact that transmission facilities are also characterized by steep scale economies. *See id.* Together, these factors show that transmission facilities have enormous "natural monopoly" characteristics, *USTA*, 290 F.3d at 427, even under the most strict definition of the term. Dennis W. Carlton and Jeffrey M. Perloff, MODERN INDUSTRIAL ORGANIZATION (2000). Dr. Shelanski is also wrong to the extent that he suggests "cost disparities" should not be considered in an economically sound impairment analysis. The very definition of an entry barrier is "a cost of producing (at some or every rate of output) which must be borne by a firm which seeks to enter an industry but is not borne by firms already in the industry." George J. Stigler, THE ORGANIZATION OF INDUSTRY 67 (1968). Indeed, in this regard, *USTA* held that "any cognizable competitive 'impairment' [must] necessarily be traceable to some kind of *disparity in cost*." 290 F.3d at 426 (emphasis added). Here, the cost disparities identified by AT&T are directly "linked" to the unique characteristics of the local exchange, and not "universal" cost disparities faced by all entrants. *See* Willig *Guidelines* Ex Parte at 8-16.

[18] Gilbert, *supra* at 527.

[19] AT&T at 145-46 (filed Apr. 5, 2002).

[20] Baumol *et al.*, *supra* at 291.

> It is generally recognized that the need to incur sunk costs can constitute a barrier to entry. Specifically, where an incumbent has already deployed sunk facilities to serve all customers, a competitive LEC may be unwilling to sink the costs of duplicative facilities, either because it may be unable to lure customers away from the incumbent and generate enough revenue to recover these sunk costs, or because resulting competition between itself and the incumbent LEC would drive prices so low that, even if the competitive LEC won a significant number of customers, it would still be unable to recover its sunk costs. In such situations, the incumbent has a "first mover" advantage.[21]

Likewise, the Commission observed in its *Section 257 Report*:

> If entry into an industry requires large sunk costs, the firm that incurs these sunk costs first (the incumbent) can have a tremendous advantage. Potential new entrants may realize that any large scale facilities-based entry into the market will probably force prices to decrease and those prices may be in fact below the point necessary to recover the sunk cost investment. As a result, facilities-based entry will be deterred.[22]

In short, as stated by one of the principal originators of the contestable market theory, a market can be considered contestable only "in certain special situations that are free of entry barriers."[23] As explained above, those special circumstances do not apply here, because there are substantial barriers to deployment of competitive transmission facilities.

Ultimately, the Commission need not guess about whether the "markets" in question are "contestable," because there is empirical proof that they are not. As noted, the very definition of a contestable market is that the threat of entry forces the incumbent to charge competitive prices for its services. In this context, that would mean that the Bells would be unable to charge more than the long run incremental cost of the services that use their high capacity transmission facilities.[24] The evidence of record shows that this is not the case. Where they have received "pricing flexibility," the Bells' special access services are priced as high as four times the long run incremental cost of the underlying facility.[25] Indeed, in this very

---

[21] *UNE Remand Order* ¶ 77.

[22] *Section 257 Report*, 12 FCC Rcd. 16802, ¶ 18 n.48 (1997).

[23] Robert D. Willig, *Contestable Market Theory and Regulatory Reform* (Conference on Current Issues in Telephone Regulation at the IC^2 Institute, Austin, Texas, Oct. 1987).

[24] *See* Baumol *et al.*, *supra* at 6, 25-29; Braeutigam, *supra* at 1340-41.

[25] *See generally* Petition of AT&T (filed RM No. 10593, Oct. 15, 2002) ("AT&T Special Access Petition") (attached to *Ex Parte* Letter from Robert Quinn to Marlene Dortch (filed Oct. 16, 2002); *id.*, Stith Dec.; *id.*, Ordover-Willig Dec.

proceeding the Bells have acknowledged, as they must, that their special access prices are well in excess of economic costs.[26]

To be sure, there has been some facilities-based entry (primarily high capacity optical transport) on some routes (primarily connecting the largest downtown buildings) in selected areas (primarily the most dense urban corridors). But this niche entry has not had any impact on the prices that the Bells charge. In fact, while the unit costs of special access have continued to decline – due both to efficiency gains in fiber electronics technology and the combination of scale economies and increased demand – the Bells have significantly *raised* special access rates where they have received Phase II pricing flexibility. In no instance have the Bells lowered their special access rates.[27] In fact, the Bells' tariffed special access rates for all MSAs where they have been granted pricing flexibility are *higher* than in those MSAs where they continue to be subject to price cap regulation.[28] If those markets were "contestable," as the Bells now claim, exactly the opposite results would obtain.[29]

Sincerely,

/s/ C. Frederick Beckner III

C. Frederick Beckner III
Counsel for AT&T Corp.

CFB:amm

[26] BellSouth at 3 (filed Apr. 5, 2001); Qwest at 7 (filed Apr. 5, 2001).

[27] AT&T Special Access Petition, Stith Dec.; AT&T Reply at 20-32 (filed RM No. 10593, Jan. 23, 2003) ("AT&T Special Access Reply") (attached to *Ex Parte* Letter from Frank Simone to Marlene Dortch (filed Jan. 30, 2003).

[28] AT&T Special Access Reply at 22-23.

[29] *Id.*, Ordover-Willig Reply Dec. ¶ 34.